THE FEDERAL CORPORATION TAX AND MODERN ACCOUNTING PRACTICE.

A PAPER BY

A. M. SAKOLSKI

[From the *Yale Review*, February, 1910.]

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CONTENTS.

IT is not uncommon in these days for legislatures to enact revenue measures in utter disregard of modern accounting principles. Unfortunately accounting terminology is frequently employed in tax legislation without reference to the proper meaning as applied in business practice. In the tax laws of many of the States, for example, "intangible assets" are defined as stocks, bonds, mortgages and other forms of securities, whereas in accounting practice the same term represents merely the "good-will, franchises, patent rights," etc., of a business. The definitions of "gross earnings," "profits," "income," "revenue," "capital," etc., are likewise frequently applied in taxation in a sense differing from the meaning ordinarily attached thereto by accountants. Disagreement and confusion in the use of accounting terms is common to much of the legislation relating to corporations. Moreover, the decisions of both the Federal and the State courts as to the proper interpretation of accounting terms are exceedingly unsatisfactory and in many cases incompatible with business practice. Any attempt to harmonize them into a set of general rules and principles appears a hopeless task. At one time the Supreme Court of the United States[1]

[1] Eyster vs. Centennial Board of Finance, 94 U. S., p. 503.

decided that "profits" are merely receipts over expenditures with no consideration given to depreciation. Other court decisions hold a contrary view, some agreeing to the established accounting principle that net profits are not finally determined until all losses due to waste, depreciation and obsolescence of both fixed and circulating assets are made good.

In view of the confusion existing in the definition and use of accounting terms by legislatures and the law courts, the recently enacted Federal corporation tax law might be expected to meet with condemnation and disapproval on the part of business men and accountants. On July 8, 1909, just previous to the final passage of the Act, a number of the leading accounting firms addressed a letter to the Attorney-General calling attention to the radical defects of the measure, which they characterized as impossible of application and utterly out of harmony with modern accounting practice. The important provisions of the law to which objections have been raised are as follows:

Sec. 38. That every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company, now or hereafter organized under the laws of the United States or of any State or Territory of the United States or under the acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association, or insurance company, equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations, joint stock companies or associations, or insurance companies, subject to the tax hereby imposed; . . . .

. . . Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint stock company or association, or insurance company, received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property; (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies the sums other than dividends, paid within the year on policy and annuity

contracts and the net addition, if any, required by law to be made within the year to reserve funds; (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, joint stock company or association, or insurance company, outstanding at the close of the year, and in the case of a bank, banking association or trust company, all interest actually paid by it within the year on deposits; . . .

Aside from the protest against the requirement that the tax return cover the calendar year, the principal criticism of the measure from an accounting view-point is directed against the phraseology defining "net income." The language of the Act is so crude and the definitions so absurd and so contrary to accepted principles of accounting that it has been justly condemned as applicable only to the bookkeeping methods of the Middle Ages. The defects can be ascribed to hasty and careless legislation. Members of Congress, with but few exceptions, were utterly indifferent to the provisions of the bill, the belief prevailing that when handled by the executive and judicial branches of the Government, the measure would reach some final adjustment, or more likely, complete extinguishment. The official interpretation of the provisions concerns us more than the language of the Act itself.

In the letter of the accountants addressed to the Attorney-General, the objections to the proposed tax were shown to center about the provision requiring "net income" to be ascertained by deducting from the gross amount of income received, expenses *actually paid,* losses *actually sustained* and interest *actually paid.* The use of the expressions "actually paid" and "actually sustained" in the calculation of net income naturally created consternation among the accounting profession. Modern accounting, especially as regards the determination of net profits, rests upon the principle that "income" is to be distinguished from "receipts" and "expenses" from "disbursements." Prior to the advent of the corporate form of business organization, bookkeeping was concerned almost exclusively with tracing out the movements of cash. The accounts showed the amounts and the sources of cash received and the manner in which it was disbursed. The main purpose of the early accounting methods

was the testing of the honesty of the employees handling cash. The gauging of the proprietors' profits or the results of individual transactions was of secondary importance. In modern times this condition is reversed. Present day accounting aims to exhibit in correct and intelligible form the net gain or loss of business operations independent of the movements of cash therein. The tracing of the *actual* receipts and the *actual* disbursements of cash, though an important part of every accounting system, has no direct relation to the results of the business operations, and is absolutely no gauge of the net losses or gains incurred in a specific period of time. Profits may be earned, though not actually realized in cash. Items of expense are frequently *incurred,* though not yet due and not yet paid. These principles are so commonplace and so widely accepted by all acquainted with business affairs that an apparent attempt to insert in a tax measure an obsolete method of determining income justly arouses the bitterest opposition.

But, whatever may have been the motives or intentions in endeavoring to define by legal enactment a method of computing net income in direct violation of prevailing practice, certainly the interpretations of the objectionable provisions of the law by the Secretary of the Treasury demonstrate that effort is made in the application of the tax to comply with actual accounting practice. The situation is interesting in view of the conflicting opinions regarding the nature of the tax expressed by the Attorney-General and by the executive officials of the Treasury Department. The Attorney-General, in his reply to the accountants, stated that the proposed tax was not on "profits" but on "the entire net income over and above five thousand dollars received by the corporation subject to the law." The return, therefore, requires statements of actual receipts and payments, and not of profits "gained," expenses "incurred," interest "accrued" and losses "ascertained." The Secretary of the Treasury evidently does not approve of this view, which assesses the tax in as absurd a manner as when a poll tax is levied according to the length of the individual's nose or the color of his eyes and the texture of his hair. The official instructions concerning the form of returns

and the manner of assessing the tax specifically state that the tax is levied on net profits. The expression "net income" is used merely "because there can be no question as to it embracing amounts of income received from . . . any source, while there might be some question as to whether or not such items would be included in the expressions 'gross profits' or 'gross earnings.'"

A detailed study of the official regulations for making up the tax returns gives convincing evidence that it is the intention of the administrators of the law to interpret the provisions as far as possible in accordance with prevailing accounting principles. The Secretary of the Treasury, when considering the vexed question of interpreting the law, is reported to have consulted eminent accounting experts, who suggested or approved the rules and regulations drafted for the enforcement of the measure. The official definitions of the terms "gross income," "income," "profits," etc., conform very closely to the definitions commonly accepted by accountants and others concerned with business affairs. The application of the tax is thereby rendered much more practicable and effective than would have been the case had the opinions expressed by the Attorney-General been allowed to stand.

The official "softening" of the objectionable provisions of the law is accomplished partly through a classification of corporations subject to the tax according to the nature of their business. From each class a separate form of return is required. The classification is as follows:

(1) Banks and other financial institutions, including insurance companies.

(2) Transportation companies.

(3) Manufacturing corporations.

(4) Mercantile corporations.

(5) Miscellaneous corporations.

Under the law no special provision is made for mining corporations, and they are classed as manufacturing companies.

The definition of net income as required by law to be stated in the tax returns is adjusted to the nature of the business of each

class. The rules prescribed are palpable efforts to correct the absurd accounting methods proposed in the law. The "gross income" of banks, insurance companies and transportation companies is officially defined as "the gross revenue derived from the operation and management of the business, together with all amounts of income . . . . derived from all other sources." The word "revenue" is undoubtedly used advisedly in preference to "receipts." The Interstate Commerce Commission designates "revenue" as the gross earnings (i. e., receipts from operation), exclusive of "income" from investments and outside sources. Miscellaneous receipts are designated in the Interstate Commerce Commission schedules as "other income" and are not included under the operating revenues. In the tax returns, however, "gross income" has a wider application than is ordinarily implied in "gross revenue," since it embraces income received from all sources, including the profits from the sale of capital assets. Assuming transactions to be on a cash basis, the "gross income" of transportation companies, according to the tax returns, conforms very closely to actual cash receipts. In the case of banks and other concerns, however, where cash or an equivalent is the commodity dealt in, a decided distinction between gross revenue and gross receipts is intended in the prescribed methods of making up the tax returns.

In the case of manufacturing and mercantile corporations, the official interpretations clearly distinguish "gross income" from "actual receipts." "Gross income" of manufacturing concerns is defined as "the total amount ascertained through an accounting (through an inventory in the case of mercantile corporations) that shows the difference between the price received for the goods as sold and the cost of such goods as manufactured." The cost of the goods "shall be ascertained by an addition of a charge to the account of the cost of the goods as manufactured during the year the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year." To the resulting balance, the items of other income or profit not already subject to the tax are to be added.

Though this method of accounting conforms to the prevailing practice, corporations making the return will experience serious difficulties from the requirement in the official regulations that in the gross income no account shall be taken of "allowances for depreciation of property nor for losses sustained which are to be taken account of in ascertaining the net income subject to the tax under the proper heading in the authorized deductions." The problem of correct depreciation accounting is extremely important in modern business operations, and an endeavor to apply specific methods, as we shall point out later, is bound to meet with serious opposition.

In reference to the statutory deductions by which net income is determined from gross income, the Treasury Department's regulations seem to controvert in every detail the language of the Act. The law as finally enacted specifically provides that "net income shall be ascertained by deducting from the gross amount of the income . . . received within the year . . . (first) all the ordinary and necessary expenses *actually paid within the year* out of the income in the maintenance and operation of its business and properties; (second) all losses *actually sustained* within the year and not compensated by insurance or otherwise, including a reasonable amount for depreciation . . . and (third) interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded or other indebtedness not exceeding the paid up capital of the corporation." Heedless of the literal meaning of these provisions, which if carried out to the letter would have rendered the Act impossible of application, the Secretary of the Treasury interprets them in accordance with correct accounting principles. He admits that "to hold that the phrase 'actually paid within the year' requires evidence of actual disbursement in cash during the year, would prohibit anything like accurate returns being made by any corporation and would render it impossible to carry out the main purpose of the law." The authorized deductions, therefore, are made to include all expense items "*acknowledged as liabilities by the corporation making the return* and which are entered as such on the books from January 1st to

December 31st." In other words, net income is to be "made up from the ledger and not from the cash book."

In asecrtaining the "ordinary and necessary" expenses included under the authorized deductions, the manufacturing and mercantile corporations carrying supplies of materials on hand are instructed to include in such expenses and charges only the cost of the materials and supplies actually disbursed and used in the operations covering the year in which the returns are made. This is demanded by every sound system of accounting. The tax return, however, covers the calendar year—a provision not objectionable in itself, but one that is likely to cause considerable expense and inconvenience to corporations with fiscal years not coinciding with the calendar year. A correct statement of profits necessarily requires the taking of an inventory or its equivalent. This generally involves considerable expense, delay and inconvenience. The necessity of a special inventory because of the tax is a just source of complaint on the part of the corporations whose fiscal year differs from the calendar year. To avoid as much friction as possible in collecting the tax for the calendar year of 1909, the instructions issued by the Treasury Department provide that "Where an inventory or its equivalent was not taken at the close of the year 1908, a supplementary statement showing such inventory approximately must be submitted with the return." No similar substitution of an inventory in succeeding years is permitted in the returns.

The requirement of a separate statement of depreciation expenses under the authorized deductions will likewise cause considerable inconvenience and difficulty to many corporations, necessitating in some instances complete alteration in the methods of computing depreciation, obsolescence and general deterioration of property. The methods of charging such losses vary with different concerns. In some industries expenses covering depreciation are intricately woven with the expenses of repairs and renewals, resulting in the absence of separate depreciation accounts. In others, again, the various kinds of depreciation and deterioration are charged to separate accounts. Some items of depreciation are properly included among the ordinary expenses of maintenance and operation, whereas other items are

met by appropriations for new construction, betterments, etc., or are met by income from special sources not credited to the revenue account. No better illustration of the complex system of charging off depreciation or extinguishment of assets prevailing in a modern corporation is afforded than that of the United States Steel Corporation. The income account exhibited in the published reports of this gigantic industrial combination shows four general items of expense wholly or partly of the nature of depreciation or amortization charges. These are

(1) Sinking funds on bonds of subsidiary companies.

(2) Depreciation and extinguishment funds (regular provisions for the year).

(3) Extraordinary replacement funds (regular provisions for the year).

(4) Special replacement and improvement funds.

These items, though partly chargeable to capital account, on the ground of promoting increased efficiency and earning capacity, are considered by the managers to be a proper charge against current earnings. Whether, under strict accounting principles they would in all cases be allowed to stand as necessary depreciation expenses under the authorized deductions is largely a matter of opinion. Depreciation accounts, reserves and sinking fund accounts are not necessarily entries of actual and tangible transactions. They are records of provisions occasioned by current or prospective losses in value. The money value of the provisions therefore must at all times be estimated, the exact amount not being capable of absolute determination in advance. The estimates, however, should be based on expert opinion and the lessons of experience, and it is a matter of business policy with accountants to leave such matters to the managers and directors.[2]

[2] The annual report of the International Harvester Company contains a lucid explanation of the character of the depreciation and extinguishment charges in a modern corporation of large size and extensive activities:

"Reserves for Plant Depreciation and Extinguishment:

"The annual appropriations from earnings for depreciation and extinguishment reserves constitute the *necessary provision* for the impairment and consumption of the plant assets utilized in the output of the product and should prove sufficient to reproduce the properties as their replacement

The diverse methods of providing for depreciation in undertakings having comparatively simple and uniform operations such as the railroad companies was well exhibited when the Interstate Commerce Commission prescribed equipment depreciation accounts for railroads. The railroad companies most active in protesting against the keeping of such accounts were among the largest and best equipped in the land. It was claimed on the part of some of these companies that the renewals and repairs to their equipment were made at a rate which tended to maintain the property at a uniform standard of efficiency at all times. Accordingly, there was no necessity for depreciation accounts on their books. A number of other railroads, including the Pennsylvania, the Baltimore & Ohio and the Norfolk & Western, provided for the depreciation of equipment largely through interest and sinking fund charges on their equipment obligations. Probably in no two important railroad systems were the methods of treating depreciation charges identical.

Although the purpose of a depreciation account is to show the amount set aside from current income for losses in the value of assets due to use or obsolescence, the methods of accounting for such losses vary according to the nature of the business and the judgment of the proprietors or accountants. Professor Lawrence Dicksee, in his standard work "Advanced Accounting," describes in detail six different methods of computing deprecia-

becomes necessary. Depreciation on plant property is based on rates established by recognized authorities. Amortization of ores is calculated at rates which will provide sinking funds sufficient to retire the whole of the Company's capital invested in mining properties before the extinguishment of the ore bodies. Timber depreciation is figured at the market values of stumpage for the various kinds of timber cut. This stumpage provision will equal the original cost of the timber properties when the present standing timber is exhausted, after allowing a fair residual value for the lands either for reforestry or for agricultural purposes.

"Special Maintenance:

"These reserves provide for relining of blast furnaces, maintenance of docks and harbors, and similar renewal work which is of a current nature, but which occurs at irregular intervals. To provide for the renewal when it becomes necessary the future cost of the work is apportioned over current operations. A reserve is also being created to provide for the elevation of certain railroad tracks in the City of Chicago, and an initial installment of $200,000.00 was set aside for this purpose in 1908."

tion, each having advantages and disadvantages. Though for general accounting purposes all methods may be equally sound, the employment of one method rather than another may result in considerable disparity in the net income of different periods. The setting aside of a fixed amount each year to cover depreciation of an important group of assets, instead of varying the amount according to the actual estimated depreciation or the actual estimated earning capacity of the assets in question, can easily result in a difference in the net earnings of the business during one year large enough to determine whether or not the tax shall be assessed. The claim may be properly made that a deficiency in net earnings in one year due to use of a varying annual rate of depreciation is offset by correspondingly increased earnings during other years, but unless it can be assumed that the tax will be fixed and permanent, this argument has no bearing on the problem under consideration.

With mining companies the question of a "reasonable" allowance for depreciation is extremely complex and difficult of exact determination. The actual depreciation of the machinery and equipment can be determined within moderate limits, but the actual diminution of value in resources due to production may baffle the wisest expert. No provision is made in the law for the progressive depreciation or amortization of mine properties, but it seems safe to conclude that the corporations can include an estimate of such charge in the expenses of the year.

The statutory requirement of a separation of depreciation charges from the ordinary and necessary expenses of operation and maintenance has an administrative advantage in gauging false returns. Unless, however, considerable freedom is permitted in estimating depreciation and similar expenses, serious friction and inconvenience will result.

The statutory provision concerning losses to be deducted from gross income covers losses that are "actually sustained." The expression "actually sustained" has been severely criticised by accountants, on the ground that the correct amount of losses chargeable against the income of a year is frequently not ascertained until a subsequent period. The distinction between losses "sustained" and losses "ascertained" is of considerable import-

ance in some industries. In transporation, in mining and in construction operations, the financial losses resulting from wrecks, accidents and other disasters are frequently not determined until after a series of adjustments or legal adjudications extending over a period of years. It is the practice of many concerns to carry suspense accounts to cover liabilities of an uncertain nature. No provision permitting this, however, is found either in the law itself or in the regulations pertaining to its execution.

The use in the law of the expression "actually paid" in connection with interest charges, if applied literally in the execution of the Act, would have been a gross violation of modern accounting practice. Interest obligations are generally payable half-yearly, but the date of disbursement varies, not only with different corporations, but with different issues of securities of the same corporation. A corporation with interest charges payable at the end of January instead of December may show a different "actual" disbursement for the calendar year covered in the tax returns than is exhibited by the books of account. The omission from the financial statements of business concerns of liabilities accrued but not actually due or disbursed, is a fruitful source of fraud and deception. Accountants and auditors guard closely against this means of misrepresentation. Hardly two years ago a secretary of a public service corporation issued a statement of net earnings on June 1 for the previous five months, putting in all the items of earnings and expense for the time, but ignoring the accrued interest on $750,000 of 5 per cent. bonds outstanding, on the ground that the coupons were not due until July 1 and were therefore not a liability at the time the statement was made up. The modern method of accounting, based on the system of accruals, is altogether contrary to this idea. It is the evident intention of the Treasury Department to follow accounting principles in spite of the phraseology of the law. "All expense items under the various heads acknowledged as liabilities by the corporations making the return are held to be proper deduction from gross income."

An interesting query arises as to whether liabilities acknowledged by a corporation on account of unpaid cumulative

dividends on preferred stock are a proper deduction from gross income. Cumulative dividends as a legal liability may differ in character from interest charges, but from a strict accounting point of view, the only distinction is that the payment of the dividends can be postponed indefinitely regardless of net earnings, whereas the interest charges are met from current income. In both cases, the charge is for the use of capital and remains a liability until paid. The general balance sheets of corporations ordinarily do not include back dividends on cumulative preferred shares among liabilities. This, however, is a matter of custom rather than reason. The indebtedness is a lien against surplus earnings and assets and is therefore a liability. In view of the accounting practice, there can be little doubt that in the returns made by corporations under the Federal corporation tax law, no deduction from gross income on account of cumulative dividend charges will be permitted though such charges may be "acknowledge as liabilities" and are "so entered on the books as to constitute a liability against the assets of the corporation making the return."

Aside from the relations of the new corporation tax law to the general principles of accounting practice a number of minor though not altogether unimportant bookkeeping and accounting problems are involved in the assessment of the tax. These will undoubtedly call for formal decisions on the part of both the administrative officials and the courts. The complexity of corporate organization and corporate activities has rendered practically impossible the intelligent and accurate statement of the financial results of business corporations in the form of a brief schedule. Considerable latitude of variation from the exact facts in any particular case may result without a "wilful intent to defraud the Government of revenue." Almost every statement of profits of a going concern, no matter how carefully and conscientiously drawn up is, at best, an estimate and not a statement of positive truth. Both English and American courts have held that inasmuch as the ascertainment of profits is necessarily a matter of estimate or opinion, "all that is required is that the estimates be fairly and honestly made without any

fraudulent intention or purpose of deceiving anyone and that they conform to the constitution of the corporation."[3] It can hardly be expected, therefore, that in the determination of net income for the purpose of tax assessment, such processes as an inventory of the material on hand, the cost of finished or partly finished goods, the wear and tear of machinery and other equipment, liability to losses from bad debts, losses from obsolescence and extinguishment of assets, etc., etc., will be accounted for similarly in all corporations and will conform in every detail to actual fact. The earning of profits represents a continuous operation. Actual results can be definitely stated only when the business is wound up and all assets realized in the form of cash.

The great diversity in the methods and activities of business corporations underlies many of the difficulties to be met with in taxing their net incomes on an equitable basis conforming to accounting practice. The endeavor to obviate these difficulties by a simple classification of business corporations into categories can be only partially successful. The methods of accounting in large corporations are frequently impractical when applied to small concerns of the same class. Capitalized items of expense in one case may constitute proper charges against income in the other, and small capitalization may effect a showing of profits which would be entirely wiped out under a large capitalization.

Without attempting to cover in detail any or all of the accounting problems which may require adjustment in the assessment of the tax upon the net income of corporations, a few will be selected as illustrations of the difficulties that may be expected in the application of a general tax on corporate incomes.

The treatment of extraordinary or extraneous income in the tax returns will undoubtedly be a source of controversy. Almost every corporation receives occasionally large items of income or experiences exceptional losses which are not the result, either directly or indirectly, of its operations. Such profits or losses may arise from the sale or transfer of fixed assets, from the issue or redemption of capital securities, or from the investment of special reserve or trust funds. The Federal law imposing

[3] A. Lowes Dickinson: "The Profits of a Corporation."

the tax on the income of corporations requires all such extraneous revenues to be added to the income of the year during which they are received and all such losses to be deducted. In the sale of fixed assets the regulations provide that

> "If the assets were acquired subsequent to January 1st, 1909, the difference between the selling price and the buying price shall constitute an item of gross income to be added to or subtracted from gross income according to whether the selling price was greater or less than the buying price. If the capital assets were acquired prior to January 1st, 1909, the amount of increment or depreciation representing the difference between the selling and buying price is to be adjusted so as to fairly determine the proportion of the loss or gain arising subsequent to January 1st, 1909, and which proportion shall be deducted from or added to the gross income from the year in which the sale was made."

This, as well as the further provision that to the price realized for the asset there should be added any amount previously charged to income which remains as a depreciation reserve to such asset, can cause no objection in theory. In practice, however, profits and losses of the nature described above are in many cases exceedingly difficult to determine. Frequently they do not appear in the income account at all, but are credited or charged directly to a reserve or an asset account. Where the losses are large, as in the dismantling of a whole plant or the abandonment of equipment rendered useless through unforeseen circumstances, the total net income of the year may be wiped out and a serious deficit result. In such case it is only fair for the corporation to provide for the loss gradually out of the profits of several years. Large profits arising from a similar source may likewise be equitably distributed over a period of years instead of being added in a lump sum to the net profits of a single year. The accounting of extraordinary gains and losses in this manner, however, although in harmony with business practice, is evidently not permitted by the regulations governing the imposition of the Federal corporation tax.

The proper distribution of the gains and losses arising from the premiums received and the discounts paid in the issue of capital securities likewise have no consideration in the provisions relating to the tax. Discounts and premiums on securities issued are an addition to or a deduction from the interest rate charged

for the use of capital. The amount thereof, accordingly, should not be charged or credited to the income of a single year. The common practice is to distribute the amount of the gain or loss over a period of years, conforming where possible to the period during which the securities are to remain an obligation of the corporation. It is very doubtful, however, whether this procedure will be permitted in the making up of the tax returns.[4]

The payments on account of sinking funds and amortization will also have an important bearing on the accounting procedure to be observed in making up the tax returns. Where sinking funds are accumulated for the purpose of debt extinguishment without reference to corresponding waste or reduction in the value of assets the payments theoretically are not a proper charge against current income. However, because of the practice of inserting provisions in trust deeds requiring the sinking fund payments to be charged to current profits in the same manner as interest, such charges in many cases are regarded as proper deductions from gross income before net income is finally determined. In order to have the tax returns conform to correct accounting principles, it is essential that the sinking fund provisions be construed in accordance with their intent. If the payments represent merely a depreciation provision, they may be construed as proper deductions from gross income. On the other hand, if the payments represent obligatory reduction or extinguishment of debt without corresponding reduction on the value of assets, they should have no place in the tax returns. The regulations of the Treasury Department contain no instructions relative to an analysis of the purpose and intent of sinking fund payments. It may be assumed, however, that the corporations subject to the tax will be allowed much freedom in the matter.

A further question of correct accounting involved in the determination of the net income of corporations subject to the tax concerns losses imputed to a decline in the market value

[4] Court decisions have held that premiums received from the issue of capital securities constitute a part of the capital of the corporation and as such are not divisible as profits among the shareholders. Premiums received from the issue of stock and bonds are usually added to the surplus of a corporation, thus becoming a part of working capital in fact as well as in theory.

of current assets. An established rule of accounting requires current assets such as raw materials, manufactured goods, etc., to be valued at cost or market value, "whichever is the lowest." A decline in market value below cost is chargeable against the business. Different methods of accounting for the loss are employed, the procedure varying according to the nature of the assets in question and the character of the business. The decline in market value may be merely a fluctuation and not a permanent loss in value. The policy of many corporations is to account for such reductions in market value through the creation of reserves among their liabilities equal to the difference between the market (inventory) value and the cost value. Charging the profits of the year with an uncertain loss is thus avoided. In making up their returns for the assessment of the tax, corporations may claim the privilege in some years of deducting from the gross income the full amount of loss represented by the declines in the market value of current assets, without crediting the profits of other years with the recovery of such losses. How far such practices will result in evasion of the tax may never be determined. Concerns having on hand large supplies of commodities such as iron ore, cotton, grain, etc., which are subject to sharp fluctations in market price, will have ample opportunity to adjust the returns to suit their purposes.

A problem of no small importance in relation to corporation profits at the present time and one that may be ignored entirely in the assessment of the tax is the treatment of so-called "paper profits." Such profits are not realized in the form of cash or its equivalent and are accordingly not brought into the revenue statement of the corporation. These profits arise usually in the exchange of assets or in the redemption of liabilities. They may, however, be the result of the revaluation of assets or the receipt of stock dividends. Although the crediting of such profits directly to surplus does not affect the income account of the year during which the profits are "written" on the books, the actual income earned in future years may be affected whenever the increased value of the assets represented by the "paper

profits" are realized in the form of cash through sale of the assets. In such an event the final realization of the "paper profits" would escape taxation, since no profits will be shown by the books of the corporation. Thus, a corporation exchanges securities of $1,000,000 cost value for other securities having no definite market value, but which are placed on the books by the directors at $1,500,000. The resulting "paper profit" of $500,000 is credited to the surplus account of the corporation, but inasmuch as nothing is received in the form of cash assets, the profit does not appear in the income statement of the year. Accordingly no tax can be assessed for the amount. During the next year, however, the securities in question are sold at their book value. The "paper profit" which was credited to surplus the previous year thus becomes an actual profit and is available for distribution among the shareholders. The amount is not subject to the tax, however, for the books show no additional income during the year from the sale of the securities, but merely a transfer of assets. Evasions of this character would not be uncommon in these days, when many of the large corporations are holding companies and mergers through exchange of securities are constantly taking place.

Many other instances may be cited of possible conflicts with modern accounting practice in the application of the Federal corporation tax. It can hardly be expected that a revenue measure of as wide an application as the one under consideration can meet all the conditions arising from the complexity of modern business organization. It seems to be the Administration's policy to interpret the provisions of the law as broadly and as liberally as is consistent with faithful execution, and corporations subject to the tax are not required to follow specific methods of bookkeeping in order to comply with the measure.

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